COPY

FILED
OCT 3 1972
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, *Petitioner*

vs.

JAMES A. BASYE AND EVELYN E. BASYE, ET AL.

Brief for Respondents

VALENTINE BROOKES
LEONARD ALLEN MARCUSSEN
LAWRENCE V. BROOKES
One Embarcadero Center
San Francisco, California 94111
Attorneys for Respondents

BORG PRINTING COMPANY OF CALIFORNIA, 548 FIRST STREET, SAN FRANCISCO 94105

INDEX

	Page
Opinions Below	1
Jurisdiction	1
Question Presented	2
Statutes Involved	2
Statement of the Case	2
Summary of Argument	7
Argument	13
Introduction	13
I. Kaiser's Contributions to the Trust Confer Entirely Contingent and Forfeitable Possibilities of Future Income on Which Respondents Would Not Be Taxable If Each One Had Contracted Directly with Kaiser Instead of Through a Partnership	14
A. Income Is Not Constructively Received So Long as the Right to It Is Contingent or Forfeitable	14
B. The Contingent Nature of the Claims to Future Income Prevents Their Being Income on the Accrual Basis	23
II. Taxpayers Are Not Taxable More Harshly Because They Are Partners Than They Would Be If They Conducted Their Practice Under Individual Contracts with Kaiser	26

Page

A. The Partnership's Income Is the Aggregate of the Earnings of Its Members, and Any Claims Which Are Not Realized Income to Them Do Not Constitute Realized Income to the Partnership 27

B. A Partner Is Not Taxed on His "Distributive Share of Any Item of Income" If His Proportionate Share of That Item Is Contingent and Unascertainable 31

C. Even If the Partnership Could Have Taxable Income Not Aggregated from the Income of Its Members, It Acquired No Interest in the Kaiser Contributions Which Would Constitute Income to It 35

III. *Lucas v. Earl* and Its Line of Precedents Are Irrelevant Here 39

IV. There Is No Carefully Devised Statutory System for Taxing Forfeitable, Contingent Future Retirement Income Which the Decision Below Could Circumvent 44

Conclusion 48

Appendix ..... appendix page 1

CITATIONS

Cases	Pages
Brown v. Helvering, 291 U.S. 193 (1934)	24
Commissioner v. First Security Bank, 405 U.S. 394 (1972)	12, 37-38, 38
Commissioner v. LoBue, 351 U.S. 243 (1956)	47
Commissioner v. Oates, 207 F.2d 711 (C.A. 7, 1953), aff'g 18 T.C. 570, Acq. 1960-1 Cum. Bull. 180	20, 21, 22, 26, 29, 48
Samuel J. and Angelina Coppola, 35 T.C. 405 (1960), Acq. 1961-2 Cum. Bull. 4	15-16
Corliss v. Bowers, 281 U.S. 376 (1930)	38
Craik v. United States, 31 F. Supp. 132 (Ct. Cl. 1940)	28, 31
Doty v. United States, 323 F.2d 649 (C.A. 6, 1963)	15
Drysdale v. C.I.R., 277 F.2d 413 (C.A. 6, 1960)	15
First Mechanics Bank v. Commissioner, 91 F.2d 275 (C.A. 3, 1937)	33
Heiner v. Mellon, 304 U.S. 271 (1938)	10, 32, 34
Helvering v. Eubank, 311 U.S. 122 (1940)	21, 22
Helvering v. Horst, 311 U.S. 112 (1940)	21, 22, 39
Helvering v. Wood, 309 U.S. 344 (1940)	15
Higgins v. Commissioner, 312 U.S. 212 (1941)	47
Hogle v. Commissioner, 132 F.2d 66 (C.A. 10, 1942)	16, 25
Jones v. Page, 102 F.2d 144 (C.A. 5, 1939)	16, 25
Lucas v. Earl, 281 U.S. 111 (1930)	7, 12, 13, 14, 21, 22, 39, 40, 41, 42, 43, 44
Massachusetts Mutual Life Insurance Co. v. U.S., 288 U.S. 269 (1933)	22

Pages

Neuberger v. Commissioner, 311 U.S. 83 (1940) 9, 10, 27, 28, 30

North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932) 8, 10, 23, 33, 34

Harold Perkins, 8 T.C. 1051 (1947), Acq. 1947-2 Cum. Bull. 3 ..... 15, 29, 46

Julian Robertson, 6 T.C. 1060 (1946), Acq. 1946-2 Cum. Bull. 4 ..... 15, 29, 46

Schaefer v. Bowers, 50 F.2d 689 (C.A. 2, 1931) 15, 29, 46, 47

United States v. Baker, 233 F.2d 195 (C.A. 10, 1956) 33

United States v. Safety Car Heating & L. Co., 297 U.S. 88 (1936) 8, 23, 24, 33, 35

CONSTITUTIONS AND STATUTES

United States Constitution, Amendment Sixteen 24, 35

Revenue Act of 1934, Section 182 33

Internal Revenue Code of 1939 (Title 26, United States Code) Section:

Sec. 22(a) 15, 16, 21
Sec. 165 46
Sec. 165(b) 46
Sec. 165(c) 15, 16, 46
Sec. 182 33
Sec. 183 28
Sec. 189 28

Internal Revenue Code of 1954 (Title 26, United States Code) Section:

Sec. 61 ..... 2, 47
Sec. 61(a) 8, 15, 16, 26

Pages

Sec. 83 (added 1969) 16, 17
Secs. 401-404 ..... 12, 26, 45, 46
Sec. 401 44
Secs. 401(c) and (d) 46
Sec. 402 2
Sec. 402(a) 13, 16, 45, 46
Sec. 402(b) 8, 12, 13, 15, 16, 26, 29, 45, 46, 47, 48
Sec. 404 ..... 2, 45
Sec. 404(a) 45
Sec. 404(a)(5) 48
Sec. 482 ..... 37, 38
Sec. 501(a) 45
Secs. 674-678 43
Secs. 701-703 9
Sec. 701 ..... 2, 9, 28, 29, 30, 31, 39, 40, 41
Sec. 702 ..... 2, 29, 30, 40
Sec. 702(b) 10, 28, 29, 31
Sec. 702(c) 31
Sec. 703 ..... 2, 9, 29, 30, 31, 40
Sec. 703(a) 28
Sec. 704 ..... 2, 34, 40
Sec. 704(a) 32
Sec. 704(b) 10, 32
Sec. 761 2
Sec. 761(c) 43, 44

Public Law 90-607, Oct. 21, 1968, 82 Stat. 1189 46

Title 28, United States Code Section
Sec. 371 20
Sec. 1254(1) 1

REGULATIONS

Pages

Treasury Regulations (26 Code of Federal Regulations) Sections:

1.61-2(d)(5) 18
1.402(a)-1(a)(1)(i) 45
1.402(b)-1(a) 8, 16, 17, 25
1.451-2 ..... 8, 17, 18, 22, 29

REVENUE RULINGS

Rev. Rul. 60-31, 1960-1 Cum. Bull. 174 ..... 19, 20, 22, 25-26, 26, 29, 48

Rev. Rul. 67-449, 1967-2 Cum. Bull. 173 17

Rev. Rul. 55-415, 1955-1 Cum. Bull. 412 ..... 28, 31

TEXTS

Jackson, Johnson, Surrey, Tenen and Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 Columbia L. Rev. 1183 ..... 30, 34

Little, *Federal Income Taxation of Partnerships* (1957 Supp.) 29

6 Mertens, *Law of Federal Income Taxation* 29

Surrey & Warren, *Federal Income Taxation* (1960 Ed.) 29

Willis, *On Partnership Taxation* (1971) 29, 30

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, *Petitioner*

vs.

JAMES A. BASYE AND EVELYN E. BASYE, ET AL.

Brief for Respondents

OPINIONS BELOW

The opinion of the district court (Pet. 15-29)[1] is reported at 295 F. Supp. 1289. The opinion of the court of appeals (Pet. 31-42) is reported at 450 F. 2d 109.

JURISDICTION

The judgments of the court of appeals (Pet. 43-48) were entered on September 16, 1971. By order dated December 10, 1971, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including February 12, 1972. The petition was filed on February 9, 1972, and certiorari was granted on April 3, 1972 (R. 220). The jurisdiction of this Court rests on 28 U.S.C. 1254(1). Extensions of time to October 5, 1972 have been granted for filing this brief.

1. The abbreviations used in this brief are "Pet." for the petition for certiorari and court opinions appended thereto; "Br." for the brief for the United States; "R." for the separately bound record; and "App." for the Appendix hereto.

QUESTION PRESENTED

Whether taxable income is realized by physicians practicing medicine as partners, in the year in which the prepaid medical plan for which they work makes contributions to a retirement plan for the participating physicians, where the participants' claims to share in them have not been fully earned but are forfeitable and will remain so until specified length of service requirements shall have been satisfied.

STATUTES INVOLVED

The statutes involved are Sections 61, 402, 404, 701, 702, 703, 704 and 761 of the Internal Revenue Code of 1954. Their pertinent provisions and those of the Treasury Regulations involved are set forth in the Appendix, *infra*.

STATEMENT OF THE CASE

Because the statement of facts made by the Court of Appeals after reviewing the record is concise and complete, we do not adopt petitioner's statement but instead restate the facts stated by the Court of Appeals in substance but not verbatim (Pet. 31-35):

The case was submitted to the district court on the parties' agreed statement of facts. Taxpayers are physicians who, during each of the tax years involved, were general partners in the Permanente Medical Group (Permanente), a limited partnership organized in 1949 to practice medicine in California. The Articles of Partnership provide that "all earnings by any of the partners from the practice of medicine * * * shall belong to the partnership," and that each partner's "compensation shall be restricted to his distributive portion of the earnings of the partnership." The partnership employed the accrual method in the information returns that it filed for the years involved in these cases; taxpayers reported their individual income by the cash method. (Pet. 31-32.)

Before the tax years in question, Permanente contracted with Kaiser Foundation Health Plan, Inc. (Kaiser) to provide medical services to members of Kaiser in its Northern California region. Kaiser, a non-profit corporation (R. 82, para. 12), operates a pre-paid hospital and medical care program for its dues paying members. The contract between Permanente and Kaiser provides for exclusivity of service—Kaiser agrees not to contract with other physicians for medical services in its Northern California region and Permanente agrees not to render such services to other direct service, prepayment plans. Under the contract Kaiser pays Permanente as compensation for the services of its physicians a monthly sum based on the size of Kaiser's membership. In addition, the contract contemplates the creation of a retirement plan to which Kaiser would make additional payments. Such a plan was established to take effect July 1, 1959, by a trust agreement between Kaiser, Permanente and Bank of America National Trust and Savings Association, as trustee.[2] This retirement plan is the focal point of the tax controversy. (Pet. 32.)

The primary purpose of the retirement plan is to insure Kaiser a stable and reliable pool of physicians providing medical service to its members. The plan accomplishes this purpose by creating an incentive for physicians to devote their careers to Kaiser members, either by remaining with Permanente or by joining some other group of physicians contracting to serve Kaiser members in one of Kaiser's other regions. (Pet. 32; the court's statement is based on R. 83, para. 16.)

Under the plan, Kaiser makes payments into the trust each month as partial compensation for the services of

---

2. The physicians worked for six months without it, because it was not adopted until Dec. 1959 but was retroactively effective on July 1, 1959. (R. 83, para. 13.)

participating physicians. Any physician with a minimum of two years service in Permanente, whether or not a partner, is eligible to participate in the plan. Each participant is assigned a certain number of "units" based on such factors as his salary, his past service with Permanente and his age at the time of his association with Permanente. The payments to the trust by Kaiser plus interest accrued on corpus less fees and expenses are tentatively credited to each participant's account in proportion to his assigned number of units. (Pet. 32-33.)

When a participant retires, the total amount allocated to his account is used to purchase a retirement annuity contract. Until then his account remains merely "tentative" because the amount allocated to it may change or his right to receive it at all may be defeated by the occurrence of one or more specified contingencies. First, if a participant in the plan leaves Permanente for reasons other than death or disability before either age sixty-five and the completion of ten years service, or the completion of fifteen years continuous service, and does not thereafter join another medical group serving Kaiser members elsewhere, he forfeits all rights to the amount allocated to his tentative account. In the case of forfeiture, the amount forfeited is reallocated among the accounts of the remaining participants; none is ever repaid to Kaiser. Second, a participant will forfeit his right to further unpaid benefits even after he has become eligible to receive them if he renders professional services for a competitor of Kaiser or if, while able to do so, he refuses to render consulting services to Kaiser or its affiliates. Third, if Permanente is dissolved or reorganized, and if at least fifty per cent of the participants in the retirement plan reassociate with the reorganized Permanente or with another group serving Kaiser members, the trust fund remains intact and unretired participants who do

not join the new group forfeit their accrued benefits. The forfeiture will not occur in two circumstances: (a) by mutual agreement Kaiser and Permanente could use the trust funds to support a new retirement plan which would preserve the tentative accounts of all participants; (b) in the case of dissolution or reorganization without the fifty per cent regrouping, the trust fund is to be liquidated and the proceeds distributed pro rata to all participants. (Pet. 33-34.)

During the four tax years involved Kaiser paid into the trust fund a total amount in excess of two million dollars. Net earnings on the corpus amounted to an additional sixty thousand dollars. Permanente did not report these amounts in its partnership income returns, nor did the partners include them in their individual returns. The Commissioner of Internal Revenue determined that the omission of these sums resulted in an understatement of partnership income and in deficiencies in the income tax returns of each of the partners. In computing the deficiencies, the Commissioner calculated the total amount of trust net receipts attributable to tentative accounts of Permanente's employees in the retirement plan, and allocated this sum among the partners according to their distributive shares of partnership income. With regard to each partner's own tentative account in the retirement plan, the Commissioner treated the "unit" allocations as a modification of the distribution provisions in the partnership agreement and assessed each partner for the annual increment attributable to his own account. (Pet. 34, 41-42.)

There is no evidence in the record to suggest that Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments. (Pet. 40.) Had a participant elected not to join the plan, he could not have received any of Kaiser's contributions as current

income in lieu of payments into the trust.[3] The tentative accounts cannot be assigned. (Pet. 36.)

"The taxpayers do not contend that the payments into the trust by Kaiser should never be taxed, but they do disagree with the Commissioner as to *when* the tax ought to be imposed and upon *whom*. Because of the substantial possibility of forfeiture of the right to receive the amounts allocated to the tentative accounts,[4] taxpayers argue, there is no current realization of income to the individual partners and taxation should be postponed until the right of receipt has become fixed. The government, on the other hand, prefers to tax now and to treat the amount on which the tax is paid as an addition to each partner's basis in his respective partnership share. Should a partner subsequently forfeit the amount in his tentative account, he would get a capital loss for that which was taxed earlier as ordinary income."[5] (Pet. 35.)

"This case thus presents the question whether the payments by Kaiser into the retirement trust were income realized by the taxpayers in the years in which the payments were made." (Pet. 35.)

---

3. The stipulation of facts states that (R. 84, para. 16): "The payments which Health Plan (Kaiser) *agreed to* . . . were paid solely to fund the retirement plan, and *were not otherwise available* to Medical Group or to the individual members or employees thereof." (Emphasis ours.)

4. "During the years 1960-1963, twenty-three physicians forfeited tentative accounts totaling in excess of $60,000.00." (Pet. 35, footnote 3).

5. "In the trial court, the government took the position that a forfeiture gave rise to an ordinary loss deduction in the year of forfeiture equal to the entire amount of tentative accruals on which the tax had been paid in earlier years. Each remaining participant then had ordinary income in the amount his account was augmented by the forfeiture." In the Court of Appeals, the government changed its position to one in which the loss is limited to a capital loss. (Pet. 35, footnote 3.)

The district court consolidated the cases for trial (Pet. 31; R. 74), decided all issues in favor of the taxpayers (Pet. 31, 29) and entered judgment accordingly (Pet. 29). On appeal the United States abandoned its contention that the investment income of the trust was taxable to the taxpayers instead of the trust (Pet. 34, note 1), but appealed the remaining issue, which is set forth immediately above exactly as the Court of Appeals stated it. The Court held "first that, viewing the taxpayers solely in their individual capacities as participants in the retirement plan, there is no current realization of taxable income." (Pet. 35.) It held secondly that assuming "without deciding, that taxability is determined at the partnership level" (Pet. 37) this partnership has not realized taxable income (Pet. 38). Its reasons cover three pages of the record (Pet. 38-40, inc.) and cannot fairly be summarized in a sentence, but we believe the climax of the reasoning is reached (Pet. 40) where the court said that the Kaiser contributions to the trust were both forfeitable and compensation not for "immediately past medical services but . . . for the continued, long-term services of individual physicians."

The decision is here for review on certiorari.

SUMMARY OF ARGUMENT

Introduction. The issue in this case is one of time: when do amounts which are forfeitable become taxable income? Petitioner's principal argument is that under *Lucas v. Earl*, 281 U.S. 111 (1930), these amounts are the income of the partnership and cannot be assigned. Yet, the issue here is not one of anticipatory assignment, but whether the Kaiser contributions have yet become income on either the cash or accrual basis.

I. A. Petitioner seeks to establish a harsher rule of taxation against taxpayers who are partners than would be

applicable under established law if they contracted as individuals. The case law, which is not based on an express statute, holds that forfeitable employer contributions to a retirement plan are not within the definition of "gross income." It, therefore, applies to independent contractors and employees alike. Present statutory law, I.R.C. Sec. 402(b), now expressly provides that if taxpayers had contracted as employees under a nonqualifying plan such as this they would not be taxable on Kaiser's contributions to the trust because their rights are forfeitable. The administrative position accepting this view of the law is shown by Treas. Reg. Sec. 1.402(b)-1(a) (affecting employees in nonqualifying plans), by Treas. Reg. Sec. 1.451-2 (affecting all persons with income claims subject to forfeiture), by published acquiescences in Tax Court cases holding that forefeitable rights in employer contributions to funded pension plans are not gross income as defined in what is now Sec. 61(a), and by two revenue rulings. It is therefore clear that, because taxpayers rights were inchoate rather than vested, no assertion of tax on these forfeitable claims would have been made if the individuals had contracted directly with Kaiser either as independent contractors or employees.

B. If taxpayers had contracted individually with Kaiser, the decisions of this Court would disapprove any assertion of liability for tax on these contingent and forfeitable claims, under either cash basis or accrual basis principles. *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932) held that where the ownership of income is contingent on the outcome of litigation and is in the possession of a receiver, it is not taxable to anyone until paid to one of the claimants. Similarly, in *United States v. Safety Car Heating & L. Co.*, 297 U.S. 88 (1936), a claim for damages for patent infringement prior to March 1, 1913 which was being contested in court on that date, was held not to be

capital on that day but to become accrued, taxable income later when the right to it was established. As Mr. Justice Cardozo expressed the rule (297 U.S. at 99), an "inchoate and disputed claim" is not accrued income. "Income * * * is the fruit * * *, not the potency fruition."

Petitioner's case, therefore, must be that taxpayers should be more harshly taxed as partners than they would be had each contracted as an individual physician.

II. A. Congress has not displayed any intention of taxing persons more harshly if they do business as partners instead of as individuals. It has said that "Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities" (Sec. 701), which shows that it thinks of them as individual taxpayers conducting business together, not as persons liable for the tax on the income of an entity. Employing the same concept, Sec. 703 commands that "The taxable income of a partnership shall be computed in the same manner as in the case of an individual * * *." This command requires that the income of the partnership be not greater than the aggregate of the incomes of the partners, computed as if each had engaged in the business as an indivdual. Since the Kaiser contributions to the trust would not be income to the individuals contracting as individuals, the contributions are not included in the income base which is aggregated to become the income of the partnership.

This literal interpretation of the statutes is supported by the legislative history (S. Rep. No. 1922. 83d. Cong., 2d Sess. (1954) p. 376), which states that in these sections (Secs. 701-703) Congress provided for conduit treatment. Finally, our interpretation is supported by this Court's position in *Neuberger v. Commissioner*, 311 U.S. 83 (1940), where this Court applied the predecessor statutes to tax a partner as if he had done business as an individual, despite

contrary implications which cannot be found in the 1954 Code, from the *expresso unius* rule of construction. In 1954 Code Sec. 702(b) Congress has codified the particular result reached in *Neuberger*.

Taxpayers are not, accordingly, taxed more harshly because they do business in partnership than they would be if each contracted with Kaiser individually.

B. Even if we assume that the Kaiser contributions to the trust could be income to the partnership, they would represent a class of income as to which the proportionate interest of each taxpayer is unascertainable because it is wholly contingent on future events. When Congress said that each partner is taxable on his "distributive share of *any item* of income" (Sec. 704(b)), it required the ascertainment of each taxpayer's distributive share of this "item of income," not merely his "distributive share" of the ultimate net income of the partnership.

The "distributive share" of each partner means merely his "proportionate share." *Heiner v. Mellon*, 304 U.S. 271 (1938). The proportionate shares of this "item of income" are unascertainable because they are contingent and forfeitable.

Income is not taxable in the year it arises, even when it is in the possession of a receiver, if the ownership of it is uncertain because it is contingent on future events. *North American Oil Consolidated v. Burnet*, *supra*, 286 U.S. 417 (1932). *Heiner v. Mellon*, *supra*, 304 U.S. 271 (1938) is consistent with this view. There the proportionate shares of the partners were known, and so was the income of the partnership in the taxable year. The argument this Court rejected was that a state law preventing distribution of the income overrode the annual accounting concept of federal law.

Lower court decisions to the contrary relied on language found in earlier statutes, which modified "distributive" by the phrase "whether distributed or not." That phrase has been removed from the 1954 Code. There is no longer any statutory premise for the conclusion that a partner can be taxed on any "item of income" when his proportionate share of it is contingent and unascertainable.

Again, the Code equates an individual and a partner and taxes neither one on income to which his claims are contingent or forfeitable.

C. Even were the entity approach adopted, Kaiser's contributions to the trust are not an "item of income" to the partnership. The determination of ultimate ownership of the "distributive" shares of this "item" was made in the agreement with Kaiser and not in the partnership agreement (Pet. 32), and the partnership could not alter the formula in the Kaiser agreement, in which age of the participant and years of service to Kaiser, rather than years of ownership of a partnership interest, are factors (R. 183). Thus, a year's service as an employee can count as much as a year's service as a partner. The partnership does not have possession, management power, or power to determine when or to whom distribution shall be made. Neither the partnership nor its members agreed to accept smaller current income in order to obtain deferred under the retirement plan (Pet. 40), for the contributions to the plan "were not otherwise available" to them (R. 84, para. 16). Moreover, all the partners may forfeit their interests, which would mean a forfeiture by the partnership of its entire interest in the contributions. Finally, the partnership is not the one who decides whether a physician is to be a participant in the plan; each physician elects this for himself (R. 165), and he need not be a member of the partnership to do so but is eligible if he is an employee

(Pet. 32-33). The Court of Appeals correctly held that even on the entity approach, Kaiser's contributions to the trust were not the income of the partnership. *Commissioner v. First Security Bank*, 405 U.S. 394 (1972), decided after the decision below, further supports our contentions, and the views of the dissenting opinions are also consistent with them.

III. *Lucas v. Earl*, *supra*, 281 U.S. 111 (1930) and its line of authority, which are petitioner's principal premise, have nothing to do with the time when a forfeitable claim becomes taxable income. This case can and should be decided without reaching any point to which that case has relevance.

The courts below fully considered *Lucas v. Earl* and distinguished it (Pet. 38-40, 20-23). The nub of the matter is that Mr. Earl was not taxed on the income he had assigned to Mrs. Earl until he had earned it and she had received it. Here, respondents have not fully earned their rights to the contfibutions and cannot do so without further years of service. Even when payments begin, the right to have them continue is contingent on the physician's availability for consultation and his non-competition with Kaiser (Pet. 33, 17-18).

There is no occasion to extend a tax avoidance doctrine such as *Lucas v. Earl* to this case where Kaiser, for its own purposes, required deferment and possibility of forfeiture. (Pet. 32.) There is no tax avoidance here. Income will not be taxed this year, but will be taxed in a later year to each taxpayer who, by ultimately satisfying Kaiser's conditions, fully earns it and becomes eligible to receive it.

IV. Petitioner's charge that the decision below frustrates Congressional purpose expressed in 1954 Code Sections 401-404, to confine tax deferment to qualified retirement plans, entirely overlooks Sec. 402(b). In Sec. 402(b), Con-

gress provided that the beneficiary of an unqualified plan shall be currently taxable on the employer's contributions, but only if his rights in them are nonforfeitable. Hence, Congress has stated its policy: it is to refrain from taxing beneficiaries of nonqualified retirement plans so long as their rights are forfeitable. The decision below applies that policy.

There is no substance to the other charge, that this decision will undermine the statutory scheme Congress has since adopted for retirement plans for the self-employed. That scheme permits income actually received by the taxpayer to be deducted by him if paid to a retirement fund, and has nothing at all to do with the taxation of contingent, forfeitable income not received or receivable.

ARGUMENT

Introduction

This case involves the taxability of contingent and forfeitable claims to future income. The petition for certiorari and the brief of petitioner assert a conflict between the decision below and both *Lucas v. Earl*, 281 U.S. 111 (1930), and twelve decisions of six courts of appeals. Those are extravagant assertions. Not a single one of the twelve court of appeals decisions involved taxability of forfeitable employer contributions, which is all this case involves.[6] Neither did *Lucas v. Earl*.

Petitioner would extend the scope of *Lucas v. Earl* far beyond what it held. Congress has expressly provided for the result we seek in all employee cases, which are the preponderant type of case. IRC Sec. 402(a), governing qualifying plans, and Sec. 402(b), governing nonqualifying

6. To avoid constant repetition of a cumbersome circumlocution, we will refer to Kaiser as "the employer" although technically it is a principal being served by independent contractors under contracts of reciprocal exclusivity. (Pet. 32; R. 82-83.)

plans, both defer the tax until receipt. The decisions below and those on which we rely all considered *Lucas v. Earl*, and found it irrelevant, as it is.

The presentation to the Court of the true picture of the law applicable to this case requires our departure from the sequence of argument employed in petitioner's brief. We must first discuss the rules which have been developed by this Court, the lower courts, Congress, and the administrator for the taxation of contingent, forfeitable claims to income, before discussing petitioner's reliance on *Lucas v. Earl* and its line of precedent.

I. Kaiser's Contributions to the Trust Confer Entirely Contingent and Forfeitable Possibilities of Future Income on Which Respondents Would Not Be Taxable If Each One Had Contracted Directly with Kaiser Instead of Through a Partnership.

A. INCOME IS NOT CONSTRUCTIVELY RECEIVED SO LONG AS THE RIGHT TO IT IS CONTINGENT OR FORFEITABLE.

The issue in this case is not whether the payments to the trust are compensation taxable as such, but whether they represent taxable income to anyone so long as they remain forfeitable. When received, they will be taxable as compensation. That concession, readily made, does not advance by one step the analysis of the question whether they have yet become taxable income.

The United States[7] argues here for a harsher result than would prevail if each physician in the Group were a sole practitioner. Its position discriminates against partners.

If each taxpayer had his own individual contract with Kaiser, either as employee or as independent contractor, the contributions to the trust would have been treated as deferred income taxable at a later date. That result would have been clearly and unarguably so, because the rights of

7. For brevity, we hereafter refer to the United States as petitioner.

each physician were forfeitable.[8] The courts below held that the same treatment was proper here. The Court of Appeals observed that petitioner did not dispute that view below (Pet. 37), but it appears to have changed its position here (Br. 22). We will establish the proposition, accordingly, in spite of our doubt that petitioner may argue here what it did not dispute as appellant below. *Helvering v. Wood*, 309 U.S. 344, 348 (1940). The authorities for our position are judicial, statutory and administrative.

Every case which has considered the question has held that participants in retirement plans do not have taxable income from contributions to their tentative accounts if their rights are forfeitable.

Several cases so held under earlier statutes. *Schaefer v. Bowers*, 50 F. 2d 689 (C.A. 2, 1931); *Julian Robertson*, 6 T.C. 1060 (1946), Acq. 1946-2 Cum.Bull. 4; *Harold Perkins*, 8 T.C. 1051 (1947), Acq. 1947-2 Cum.Bull. 3. Each of these cases involved taxable years before the forerunner of Sec. 402(b), [Sec. 165(c) 1939 Code] was adopted. Each one therefore interpreted Sec. 22(a) of the former statutes, which contained the definition of income now found in Sec. 61(a), 1954 Code, on which petitioner relies here. It is of interest that in *Schaefer v. Bowers, supra*, which is the parent case of the rule, it was the government which successfully argued for the rule.

Under the 1954 Code, *Drysdale v. C.I.R.*, 277 F. 2d 413 (C.A. 6, 1960), also so held as an interpretation of the definition of gross income. *Doty v. United States*, 323 F. 2d 649 (C.A. 6, 1963) and *Samuel J. and Angelina Coppola*,

---

8. Both lower courts found that the physicians' interests here were forfeitable when the payments into the trust were made. (Court of Appeals, Pet. 33; District Court, Pet. 17.) The United States does not dispute the fact (Br., p.5).

35 T.C. 405 (1960), Acq. 1961-2 Cum.Bull. 4 reached the same result in nonqualified plans under 1954 Code Sec. 402(b).[9]

The meaning of the definition of gross income is the same for an independent contractor as for an employee, so the cases interpreting former Sec. 22(a) [now Sec. 61(a)] did not turn on the status of the taxpayers as employees and are equally applicable to independent contractors. The same is true of *Drysdale, supra*, which involved Sec. 61(a) of the 1954 Code.[10]

The statutory authority is 1954 Code Sec. 402(b) as it read continuously from 1954 to 1969.[11] Briefly, it provides that payments by "an employer" to a "nonexempt trust" shall be "included in the gross income of any employee for the taxable year in which the contribution is made to the trust" only if the interest of the employee in that contribution is "*nonforfeitable* at the time the contribution is made."[12] (Emphasis ours.) Rarely does the Internal Revenue Code speak so clearly.

---

9. Treas. Reg. 1.402(b)-1(a), discussed *infra*, p.17, is now to the same effect.

10. Neither of the two cases petitioner cites for an opposing result [*Hogle v. Commissioner*, 132 F. 2d 66 (C.A. 10, 1942) and *Jones v. Page*, 102 F. 2d 144 (C.A. 5, 1939)] involved forfeitable or otherwise contingent amounts and both involved taxability in the year of actual receipt.

11. Prior to 1969, Sections 402(a) and 402(b) placed the employee beneficiary of a qualified plan and that of an unqualified plan in exactly the same tax posture if the rights of the employee-beneficiary were forfeitable in the year the payment to the trust was made. As amended in 1969, Sec. 402(b) requires consideration of a new section, Sec. 83, but the two sections together continue to defer taxability until there is no longer a "substantial risk of forfeiture." The amendments are not retroactive. Section 402(b) is derived from Sec. 165(e) of the 1939 Code, which appeared in the 1942 Act.

12. This section is not referred to in either the brief for the United States or its petition for certiorari. Its complete text is in the Appendix, as are those of all statutes and regulations cited.

The administrative position is shown by the three acquiescences in Tax Court decisions noted above, by published rulings, and by Regulations. One ruling is Rev. Rul. 67-449, 1967-2 Cum.Bull. 173. It reveals how firm the rule is, because it held that the employee was not currently taxable on forfeitable contributions, even though he elected to participate in the forfeitable plan instead of receiving alternative benefits, because he was not in constructive receipt of them. Treas. Reg. Sec. 1.451-2, defining constructive receipt, was relied on and hence the ruling is not confined to employees.

Finally, the administrative view is shown and, we should have thought but for the petitioner's arguments here, foreclosed, by Treas. Reg. Sections 1.402(b)-1(a) and 1.451-2 (Appendix, *infra*). The first regulation repeats the statutory provision that the employer's contribution to the trust shall be included in the employee's income only if "nonforfeitable at the time the contribution is made," and then adds that if the contributions were forfeitable at the time they were made they do not become taxable to the employee until actually paid to him. Only the last sentence of the regulation may have been changed by the 1969 amendment to the Code, which has added Sec. 83 and may impose some tax when the employee's interest vests; i.e., becomes nonforfeitable.

The second regulation is Treas. Reg. Sec. 1.451-2. It defines "Constructive Receipt of Income" as:

> "Income . . . not actually reduced to a taxpayer's possession (but) . . . credited to his account, set apart for him, or *otherwise made available* so that he may draw upon it at any time." (Emphasis ours.)

The stipulation of facts states that:

> "The payments which Health Plan (Kaiser) agreed to . . . were paid solely to fund the retirement plan,

and *were not otherwise available* to Medical Group or to the individual members or employees." (Emphasis ours.)

The stipulation in the exact words of the regulation means the payments were not constructively received, and the court below so held.

Moreover, the regulation continues by saying:

". . . . However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." (Reg. 1.451-2).

There can be no doubt that the physicians' "control of the receipt" of the contributions here in question was "subject to substantial limitations or restrictions," since the contributions were forfeitable when made and in the case of one respondent have actually been forfeited (Pet. 20, footnote 3). Here, then, is further administrative evidence that had the physicians contracted directly with Kaiser, the result below would have been unquestioned.

No distinction is made in Treas. Reg. Sec. 1.451-2 between employees and independent contractors, so nothing would have turned on which status they assumed. Indeed, Treas. Reg. Sec. 1.61-2(d)(5), interpreting the income status of property transferred as compensation but subject to restrictions, expressly states that the same rules apply to independent contractors as to employees.

Income cannot be said to have been earned if its receipt is subject to the requirement that the earner perform future services. Moreover, such a requirement involves a possible forfeiture and prevents constructive receipt of income which a taxpayer may never receive. As we shall show, *infra* B, it would also prevent the accrual of in-

come.[13] Such a requirement is of critical importance where the employer pays the contributions over to a trustee or other third person for the taxpayer's possible ultimate benefit. But its absence is not critical where the employer merely promises to pay fully earned but nonfunded compensation in the future. There, the fully earned but deferred income is not taxable until paid if the contract deferring the payment is made before the services are performed, whether the deferred income is forfeitable or not.

The Revenue Service has so ruled in Rev. Rul. 60-31, 1960-1 Cum.Bull. 174, where it analyzed the court decisions and stated its interpretation of them in five situations involving earned but deferred compensation, four of which were not payments to a trustee or otherwise funded. The ruling agrees that where compensation is earned after an employment contract has been signed and that contract provides that a portion of the compensation earned will be withheld by the employer and paid to the taxpayer when he retires, but without purchase of an annuity, or other funding, the tax is not due on the withheld income and is deferred until the income is actually received by the employee. The ruling is not confined to employee cases, because one example given of properly deferred income is that of an author and his publisher.[14]

Forfeitability is not a requirement for the deferral of income approved in Rev. Rul. 60-31 where the employer does not fund the obligation by paying the withheld funds to a trustee, or by buying an annuity.

---

13. As the Court of Appeals stated (Pet. 32-33), the principal purpose of the entire plan was Kaiser's purpose to bind the physicians to its service, and the forfeiture provisions were the keystone.

14. This is a cash basis ruling. Respondents are all on the cash basis (Pet. 32). Because the partnership is on the accrual basis (Pet. 32) we show in point IB, *infra*, that forfeitability also prevents accrual.

In that ruling, the Revenue Service also announced its acquiescence in *Commissioner v. Oates*, 207 F. 2d 711 (C.A. 7, 1953), affirming 18 T.C. 570. 1960-1 Cum.Bull. at p. 180. The facts from the ruling which we have stated above were substantially those of the *Oates* case, except that in *Oates* the employer who withheld the deferred income was Northwestern Mutual Life Insurance Company, and Oates was a partner in a general insurance agency and hence an independent contractor like respondents here. Where deferred compensation is funded by the purchase of annuities, companies like Northwestern are the underwriters of the annuities. The Service's position is that if the employer buys an annuity for someone who performs services for it, payable in the future, the employee is immediately taxable on the premium unless the policy is forfeitable, but if the same company as employer promises to pay in the future, and if the contract so providing is in existence when the services are performed, as was the case in *Oates*, the deferred compensation is not taxable until received, even if it is not forfeitable. Rev. Rul. 60-31, *supra*.

No better illustration of the rules can be found than the tax status of payments to federal judges who are entitled to retire on full compensation. The governing statute provides that when one of the prescribed combinations of age and length of service occurs, the judge becomes eligible to resign or retire, and in either case to continue to receive his full salary for life. Title 28, United States Code Sec. 371. Although he is free without forfeiture to postpone his retirement after eligibility vests, he does not increase his income by so doing. Nor does he, by accepting temporary judicial assignments after retiring, succeed in increasing either his judicial salary or his retirement annuity, for they are the same in amount.

Thus, the judge has fully earned his retirement compensation at the moment he becomes eligible for retirement.[15] Nothing more need be done to assure him the continuation of his full judicial salary for the rest of his life; his rights have fully vested. The same argument, that he has constructively received it all at that moment,[16] could be made as the Commissioner made in the *Oates* case. The Tax Court summarized the Commissioner's argument and its own views as follows (18 T.C. at 585):

> "Respondent in contending that the amounts in question are taxable to petitioners under section 22(a) largely relies on *Lucas v. Earl*, 281 U.S. 111, *Helvering v. Eubank*, 311 U.S. 122, and *Helvering v. Horst*, 311 U.S. 112. We fail to see where those cases have any application here. Those are cases where the income had been assigned to another and the taxpayer was contending that the assignment relieved him of taxation on the income and that the income was taxable to the one to whom it had been assigned. We have no such question here. Petitioners are making no contention that the commissions credited to their accounts by Northwestern in the taxable years will not be taxable to them if and when they receive them. Their contention is that under their amended contracts which were signed prior to their retirement they were not entitled to receive any more than they did in fact receive and that being on the cash basis they can only be taxed on these amounts and that the remainder will be taxed to them if and when received by them. For reasons already stated, we have sustained that contention. Reviewed by the Court."

The Commissioner was not satisfied and appealed. The Court of Appeals affirmed the Tax Court, agreed with the

15. This is not the case with respondents here, who must continue after retirement to perform consultative services and refrain from serving competitors, in order to avoid forfeiture. (Pet. 33; R. 169-170, Sec. F-4.)

16. Subject to discount for postponement of possession.

taxpayer, and also rejected the argument based on *Lucas v. Earl*, *supra*, 281 U.S. 111 (1930), *Helvering v. Eubank*, 311 U.S. 122 (1940),[17] and *Helvering v. Horst*, 311 U.S. 112 (1940).

The court held that this Court's decision in *Massachusetts Mutual Life Insurance Co. v. U. S.*, 288 U.S. 269 (1933) was the controlling precedent,[18] rather than *Lucas v. Earl* and the cases like it.

As we have shown, the Commissioner has acquiesced in the *Oates* decision and has published Rev. Rul. 60-31, 1960-1 Cum.Bull. 174, to inform both the Revenue Service and the taxpayers that he has done so, and to state analagous facts as illustrations of acceptable tax deferment of earned but unpaid compensation.

Neither Oates nor the federal judge knows how much he will ultimately receive as retirement compensation because the payments end at death. The same is true of the taxpayers here. This is one objection to taxing taxpayers currently on their future terminable income, but there is another, which is that their rights, unlike those of the retired judge and Oates, have not vested.

The foregoing examples of the recognized rules illustrate the meaning of the Regulation which defines income as not constructively received (Reg. 1.451-2, quoted above) "if the taxpayer's *control* of its receipt is subject to substantial limitations or restrictions." (Emphasis ours.) The control the taxpayer lacked in *Oates* is over the time of

---

17. Contrast of *Eubank* with *Oates* reveals the importance of the distinction between assignment of income, which *Eubank* forbade, and deferral of income, which *Oates* permits. Otherwise they are similar, even to the fact that both involved retired general insurance agents. This important distinction petitioner ignores.

18. Where interest credited but not paid by a cash basis insurance company to cash basis policyholders was held to be neither constructively received by the latter nor constructively paid by the former, and hence was not deductible or taxable until paid.

receipt, and the same control is lacking in the judge who qualified for retirement, and the physician here. Because the justification of the progressive income tax is ability to pay, that tax does not ignore restraint on availability of funds with which to pay.

B. THE CONTINGENT NATURE OF THE CLAIMS TO FUTURE INCOME PREVENTS THEIR BEING INCOME ON THE ACCRUAL BASIS.

The result is the same if accrual basis principles are supplied. The rule is that the possibility of forfeiture prevents these contributions accruing as income until there arises an enforceable right to receive them. This rule is fully supported by three landmark decisions of this Court. The earliest in time is *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932), where net proceeds were received in 1916 by a receiver who was operating properties until litigation over their title was settled. The corporate claimant was on the accrual basis. The income was paid over to the corporate claimant in 1917. This Court held that (286 U.S. at 423):

> "... the company was not required in 1916 to report as income an amount which it might never receive."

The Court of Appeals relied on this case for its conclusion that taxpayers' forfeitable rights could not have accrued as income (Pet. 40).

The second case is *United States v. Safety Car Heating & L. Co.*, 297 U.S. 88 (1936), where a claim for damages for patent infringement prior to March 1, 1913, was contested in litigation pending on that date, and was held not to have become income to an accrual basis taxpayer before that date. Since Congress could not have taxed the recovery at all had it been income before that date, the case is a particularly powerful precedent for the rule that income does not accrue as income while the right to own it is contingent.

Some of Mr. Justice Cardozo's words for the Court bear quotation here:

> "In February, 1913 . . . there was a contested and contingent claim for profits, not fairly to be characterized as income for that year or earlier. In 1925, this inchoate and disputed claim became consummate and established. It was now something more than a claim. It was income fully accrued, and taxable as such. . . .
>
> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition." 297 U.S. at 99.

It is equally true that income within the meaning of the Sixteenth Amendment is the fruit born of labor, "not the potency of fruition." The physicians' contingent and forfeitable expectations have merely the "potency of fruition" and will not fruit as income until the contingencies are removed. Hence, if they had contracted directly with Kaiser, they would not have income in these years from Kaiser's contributions to the trust, even on the accrual basis.

The third case is *Brown v. Helvering*, 291 U.S. 193 (1934). Although a deduction case, it perfectly illustrates the inflexability of the rule that an enforceable obligation is required before an item can accrue. An insurance agent on the accrual basis attempted to deduct an estimated amount of anticipated return commissions from his gross commission income, and his estimate was based on the percentage of commissions he had been compelled to return in the prior years. In an opinion written by Mr. Justice Brandeis, the Court allowed him to accrue and deduct only those commissions he had become obligated to return in the current year. Probabilities would not support an accrual. Thus, even if it could be said that a physician probably would work for Kaiser until his rights vested in order to avoid

a forfeiture,[19] that probability would not support the accrual of contingent and forfeitable income.

Petitioner cites two cases (Br. 22)[20] for its assertion made here but not below that even if the physicians had contracted individually with Kaiser they would be taxable on the forfeitable payments. Neither case has any bearing on the question when items accrue as income. In each case, the income was in hand, but it was in the assignee's hand. The fact the assignor was held taxable in the year his assignee received the income cannot possibly support the view that income is taxable as accrued income while the taxpayer's rights to it are, in Mr. Justice Cardozo's words, "inchoate."

We need not carry the burden of contending that the distinction between the funded pension and the nonfunded pension is technical and artificial, though this may have occurred to the Court. It may appear artificial that if Northwestern Mutual Life had funded its obligation to Oates by placing some of its portfolio of federal bonds in a trust for him, or if the United States should fund its obligation to its retired judges by buying them annuities from Metropolitan Life or Northwestern Mutual, that would convert their status to instant taxability. The improvement in their assurance of future security is hard to detect, but in the Commissioner's eyes their tax status is infinitely worse, for they become subject to current taxation on the cost or value of the annuity contract. (Reg. 1.402(b)-1(a)(2)). Rev. Rul.

---

19. The record contradicts an assertion of such probability. Respondent Sorokowski has forfeited her interest (Pet. 20) and so have 23 other physicians (Pet. 35). In the court below petitioner took the position that they were entitled to a capital loss deduction for the lost income (Pet. 35) which, however, it would first tax as ordinary income.

20. *Hogle v. Commissioner*, 132 F. 2d 66 (C.A. 10, 1942); *Jones v. Page*, 102 F. 2d 144 (C.A. 5, 1939); we have previously referred to them in footnote 10, *supra*, p. 16.

60-31, 1960-1 Cum.Bull. 174 expressly excepts funded plans from the deferment it recognizes.

This distinction between funded and nonfunded plans underlies petitioner's case here, since without it we would have the *Oates* facts, the acquiescence in it, and Rev. Rul. 60-31. We need not challenge the distinction, however, since it must be based on 1954 Code Sec. 402(b),[21] and that section expressly states its own limitation: the employee is taxable on the employer's payments into a non-exempt retirement trust only if the employee's interest is "nonforfeitable" when the payment is made.[22]

Accordingly, the position of petitioner is reduced to the proposition that, because taxpayers practiced their profession as partners, they are to be discriminated against harshly and cannot take advantage of the equitable rules established by the courts and Congress for those who contract as individuals, either as independent contractors or as employees. We shall next show that the law does not make that harsh and unjust discrimination.

II. Taxpayers Are Not Taxable More Harshly Because They Are Partners Than They Would Be If They Conducted Their Practice Under Individual Contracts With Kaiser.

The taxpayers' economic status resembled that of employees more than that of independent physicians in private practice. By joining the partnership, they became obligated to serve Kaiser with "all or substantially all of their professional time" (R. 103, cf. R. 161) so long as the contracts were in force, and if they violate that obligation before re-

---

21. Which by its language applies only to employees, as does the entirety of Sections 401-404, inclusive.

22. As we have shown above (at pp. 15-16), the uniform rule of the court decisions interpreting what is now Sec. 61(a) also limits taxability to instances when the beneficiary's interest is nonforfeitable, and the Commissioner has acquiesced in them. Hence, they apply to independent contractors as well as employees.

tirement at sixty-five or fifteen years service, they forfeit all right to retirement payments from the fund established by Kaiser's contributions here in issue, as respondent Sorokowski has done (Pet. 20, N. 3).

A. THE PARTNERSHIP'S INCOME IS THE AGGREGATE OF THE EARNINGS OF ITS MEMBERS, AND ANY CLAIMS WHICH ARE NOT REALIZED INCOME TO THEM DO NOT CONSTITUTE REALIZED INCOME TO THE PARTNERSHIP.

It is their status as partners on which petitioner bases its entire case that harsher rules apply to the taxpayers than to employees and independent contractors. Petitioner's case is without merit. Except where expressly stated exceptions are provided by Congress, an individual is taxed the same whether he engages in business as an individual proprietor or as a partner.

This Court held, prior to the 1954 Code, that only where Congress has explicitly so provided will a person's doing business in partnership produce a less favorable tax result than if he did business as an individual. *Neuberger v. Commissioner*, 311 U.S. 83 (1940). The Commissioner had there argued that the doctrine of *expressio unius* produced a literal interpretation of the statute which denied a partner the same right to offset partnership profits from securities sales against his individual securities losses as he would have enjoyed had he done both in his individual capacity. This Court held that *expressio unius* is merely a rule of construction and gave rise to no more than an inference. It refused to treat the partnership as an entity and held that the purpose of Congress to treat the partnership as a reporting aggregate of individual taxpayers was clearly stated, and except where exceptions were expressly stated no construction of the statute was permissible which im-

posed higher taxes on partners than on taxpayers engaged in business as individuals.[23]

The 1954 Code should be interpreted in the same manner. Congress has said so in positive fashion. Thus, it has said in Sec. 701 that "Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." The emphasis is on "persons carrying on business" and displays the Congressional concept that they are "persons carrying on business" and not persons owning a business entity on whose income they are taxable.

Congress has codified this Court's *Neuberger* decision in Sec. 702(b), by this language:

> "Character of Items Constituting Distributive Share. — The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."

Finally, Congress has continued the 1939 Code provisions of Sections 183 and 189 by stating in Section 703(a):

> "The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—" [Listing 15 exceptions, none of which apply here].

To comply with the language of Section 703 requires initially the determination of what income each partner would

---

23. In *Neuberger* this Court also cited *Croik v. United States*, 31 F. Supp. 132 (Ct. Cl. 1940) with approval (311 U.S. 83, 85, 88). In *Croik* a nonresident alien partner in two U. S. based partnerships was held entitled to exclude from taxable income his share of the foreign source income of the partnership, the court saying that the tax law taxed a partner "as though (the income) had been received by the partner directly" (31 F. Supp. at 134). In Rev. Rul. 55-415, 1955-1 Cum.Bull. 412, the Revenue Service acknowledged that the *Croik* case was approved by this Court in *Neuberger*.

have had as an individual practitioner under contract to Kaiser, and then the aggregation of those incomes.[24] The forfeitable contributions would not have been taxable income to him whether he was technically an employee [Sec. 402(b)] or independent contractor [*Schaeffer v. Bowers*, 50 F. 2d 689 (C.A. 2, 1931); *Julian Robertson*, 6 T.C. 1060; *Harold G. Perkins*, 8 T.C. 1051; Treas. Reg. Sec. 1.451-2: and cf. Rev. Rul. 60-31, and *Commissioner v. Oates*, 207 F. 2d 711, all cited *supra*]. Because the partnership's income is computed as would be that of an individual performing under a similar contract, these contributions are not includible in its income. The Court of Appeals construed Sec. 703 in that manner (Pet. 38), and did so correctly.[25]

Sec. 702(b) also contains clear inferences supporting that interpretation.[26] It directs the "flow through" of certain income, credits and deductions from the partnership to the partner, in character or classification though not, of course, in amount. As noted above, this is the codification of *Neuberger*. It means that the income, credits and deductions aggregated by a group of individuals engaged in business in partnership remain those of the individuals and their

---

24. "Thus, for the purpose of tax liability the entity approach yields to treatment of the partnership as a conduit through which the individual partners are regarded as *receiving the income so computed as if they had earned it individually*." (Emphasis ours.) Surrey & Warren, *Federal Income Taxation* (1960 Ed.) pp. 1115-16.

25. From the earliest (Little, *Federal Income Taxation of Partnerships*, 1957 Supp. pp. 126-127) to the most recent (Willis *On Partnership Taxation*, 1971, pp. 41-42), the text writers agree that 1954 Code Sections 701, 702 and 703 adopt the "conduit" theory. So does Mertens (6 Mertens, *Law of Federal Income Taxation*, p. 82.)

26. Its language is:
"The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."

character is not altered because they have been divided into proportionate shares. This needed saying and was not necessarily to be implied from Sec. 703 because the argument could be made, as it was unsuccessfully in *Neuberger*, that having passed through the individual to the partnership it lost its original character, and on becoming "distributive" to the partner had its original character lost or blended into something neuter called "distributive income." So it was said, in order to forestall a repetition of the arguments quieted in *Neuberger*.

The Committee Reports show that we correctly analize the Congressional purpose. The Senate Finance Committee report says of Sec. 702 [S. Rep. No. 1622, 83d Cong., 2d Sess. (1954), p. 376]:

> "This section represents no change in current law and practice. . . .
>
> "Paragraphs (1) through (7) of section (a) specifically require conduit treatment with respect to several major items of income, deductions, etc. . . .
>
> "Subsection (b) contains a 'conduit' rule which makes clear that the character of any item realized by the partnership. . . .shall be the same as though he had realized such item directly. . . ."

The reference to "conduit" treatment recognizes that the income of the partnership is merely the aggregate of that earned by "persons carrying on business as partners" (Sec. 701), and unless they first have income they cannot be the conduits through which it flows to the partnership.[27]

---

27. Concerning Sections 701 and 703, the Committee Reports state that they also continue existing law. S. Rep. No. 1622, 83d Cong, 2d Sess., pp. 376, 378. See Willis, *On Partnership Taxation* (1971), Sec. 1.03, for an analysis of the varying use by Congress of both the conduit (aggregate) and entity concepts. See also the discussion in Jackson, Johnson, Surrey, Tenen and Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 Columbia L. Rev. 1183, 1185-6. The authors of that article were instrumental in framing the American Law Institute draft, from which the partnership sections of the 1954 Code were largely drawn.

When Sec. 701, Sec. 702(b) and Sec. 703 are put together, we observe a clear statutory mandate that a partnership has income only if its member first has income to contribute to it, and the character of the income flows from the partner to the partnership and back again. If its character is not taxable income to the partner contributing it, neither is it to the partnership.[28]

Petitioner's contention that the partnership had entity income which its members, had they contracted directly, would not have had, is contrary to the language of the statute, its legislative history including this Court's *Neuberger* interpretation of the predecessor statute, and the detached views of authors. It gives no effect to the necessary implications of Sec. 701, and fails to give effect to Section 703. The statute says that "The taxable income of the partnership shall be computed in the same manner as in the case of an individual," (Sec. 703), and this cannot be done if the partnership has more income than the aggregate which the individuals comprising it would have had if they had done the same business as individuals. Since each individual's interest is forfeitable and has not ripened into income, it is not taxable income to the partnership.

The lower courts so held, and correctly. In refusing to charge Congress with a purpose to discriminate harshly against taxpayers because they formed a partnership instead of contracting individually, they reached the fair result which Congress has said it intended.

B. A PARTNER IS NOT TAXED ON HIS "DISTRIBUTIVE SHARE OF ANY ITEM OF INCOME" IF HIS PROPORTIONATE SHARE OF THAT ITEM IS CONTINGENT AND UNASCERTAINABLE.

An alternative argument not made below but available to us here since we are respondents, is that a partner's

---

28. Also, the partner is the owner of his proportionate share of the partnership's gross income, not merely of his distributive share of its net income. Sec. 702(c). This section codifies the rule of *Craik v. United States*, 31 F.Supp. 132 (Ct. Cl. 1940), *supra* note 23. See Rev. Rul. 55-415, 1955-1 Cum.Bull. 412.

"distributive share of income"[29] does not include any "item of income" in which his proportionate interest is unascertainable. Here, we assume for argument's sake the Kaiser contributions are a current "item of income." Under Sec. 704(b), a partner is taxable on his "distributive share of any item of income." We believe that "distributive share" means the share the partner has a right to, and does not include any "item of income" to which his proportionate interest is contested, or contingent, or forfeitable and hence inchoate. This result flows from settled principles of tax law, and preserves equality of treatment between persons doing business as individuals and those doing so as partners.

Petitioner cites *Heiner v. Mellon*, 304 U.S. 271 (1938), for the contrary of this proposition, but mistakenly. In *Heiner v. Mellon*, the proportionate shares of the partners were certain and not in dispute. The dispute was over the question whether each was taxable on his known proportion of the year's net income, when the income was not distributable under local law and was subject to being wiped out by possible later losses. This Court held that "distributive" means "proportionate" (304 U.S. at 280), and, recognising that every business is taxable on its net income for that year even though that income remains at the risk of the business, sustained the tax on the known share of each partner in that year's net income.

Here, though, the proportionate share of each partner in Kaiser's contribution to the trust is entirely unknown and speculative. Each partner may prove to have no interest in it at all, and there is an equal possibility that he may have a greater interest than his present proportion because of the tontine effect of forfeitures by others.

---

29. Section 704(a).

Let us test the meaning of "distributive" by a variation of the facts in *North American Oil Con. v. Burnet, supra,* 286 U.S. 417. That is the case where this Court held that a taxpayer was not taxable on income in the possession of a receiver pending litigation over the taxpayer's ownership of it. Let us consider the case of a partnership whose assets are being operated by a receiver pending disposition of litigation in the state courts in which two partners each claim a fifty per cent interest and a third one claims a one-third interest. The federal courts cannot use a tax case to render a binding adjudication of ownership so if they decide that the men are each taxable on one-third as their respective "distributive" shares, they may well tax one taxpayer on income he has no legal right to and the others on less than they own. In such a case we believe no partner can be taxed on a share he may be held in pending litigation not to own, and as in *North American Oil* and *U. S. v. Safety Car Heating & L. Co., supra,* taxation is suspended until ownership is determined.

Under the prior law, a few cases were decided contrary to this contention.[30] The most recent is *United States v. Baker,* 233 F. 2d 195 (C.A. 10, 1956), which reviews the cases on both sides. It and the cases like it relied on language in former law that a partner was taxable on his distributive share, "whether or not distribution is made."[31] The quoted words were omitted from the 1954 Code and no equivalent form of expression was substituted. We believe the *Baker* case and like cases were incorrectly decided even under prior law. It is an error

30. Every case petitioner cites (Br. 20) arose either under the 1939 Code or predecessor acts.

31. Sec. 182, 1939 I.R.C. The parent case in that line interpreted Sec. 182, Rev. Act of 1934, which taxed "his distributive share, whether distributed or not." This case was *First Mechanics Bank v. Commissioner,* 91 F. 2d 275 (C.A. 3, 1937). It was lost by the Commissioner where we believe he was right. The result in the case is a perfect illustration of why that result is wrong.

in logic to reason that because a distributive share is taxable even if not distributed it is taxable even if not known. There is no justification for the assumption made in those cases that taxes must be paid on one hundred per cent of a partnership's net income each year, regardless of uncertainties of ownership. The Code never did say so, and there is no more reason to imply such a requirement to do injustice than in the statutes involved in *North American Oil, supra*, where the 1916 income in the hands of the receiver went untaxed until 1917. Ordinarily, all the net income of a particular year is taxed to someone, but not when the proportionate ownership shares are in dispute.

But the Court need not decide whether those cases were correctly decided under prior law. Perhaps the phrase "whether or not distribution is made" was omitted to change the result of those cases.[32] Perhaps it was omitted as both mischievous and unnecessary, since it is necessarily to be implied from the holding (*Heiner v. Mellon, supra*) that "distributive" means "proportionate". Whatever the reason for the change, there is presently no statutory basis for taxing disputed or otherwise unascertainable "distributive" shares of partnership income any differently than other types of contingent income. If there ever was any statutory

---

32. The legislative history does not say. The discussion of "distributive" shares is about the adoption of the "entity" approach in respect of some provisions involving the effect of the contribution of appreciated basis property on a partner's distributive share, and the "aggregate" approach being offered as an election to be made by the partnership in such instances. S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 89-94. The discussion in Jackson, Johnson, Surrey, Tenen and Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 Columbia L. Rev. 1183, 1187 et seq., *op. cit.*, does not explain omission of the phrase, either, or discuss the effect of uncertainty of distributive shares. It does state, however, that Sec. 704 permits different distributive shares for each item of income. 54 Columbia L. Rev. at 1187. Hence, the fact that the uncertainty of the distributive shares relates only to one item does not prevent the other distributive shares being taxed.

basis for such discrimination against partners, it has been removed.

Our construction of the statute also avoids a serious constitutional issue. Income is to be taxed to the owner, not to a mere claimant not in possession. To a mere claimant it is inchoate, not yet income under the Sixteenth Amendment. *United States v. Safety Car Heating & L. Co.*, *supra*, 297 U.S. 88 (1936).

For the same reasons, monies these partners had no control over, no right to receive, and which were mere future claims subject to forfeiture, were not part of the "distributive" shares of the partners. Assuming that the Kaiser contributions were "an item of income" to the partnership, each partner's proportionate share in it was unpredictable and unascertainable, so it is not taxable until his share is known.

C. EVEN IF THE PARTNERSHIP COULD HAVE TAXABLE INCOME NOT AGGREGATED FROM THE INCOME OF ITS MEMBERS, IT ACQUIRED NO INTEREST IN THE KAISER CONTRIBUTIONS WHICH WOULD CONSTITUTE INCOME TO IT.

The Court of Appeals held that even on the entity theory, assuming without deciding its validity, the partnership did not have income from Kaiser's contributions to the trust (Pet. 37-38). It observed that those contributions were in addition to the payments for services made currently, and the contractual scheme did not contemplate that those contributions would be paid to the partnership for it to disburse to its members (Pet. 40). It pointed out that the contributions to the plan are "in addition to" the regular compensation and the latter would not have been increased had there been no plan. (Pet. 40.) It said that the record is barren of evidence to suggest that the partnership "agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments," and that the Kaiser

contributions "were not otherwise available" to the partnership, its members or employees, except as additions to the corpus of the fund. (Pet. 40.) Moreover, the record shows that a participant in the plan must elect to be included (R. 164-165), and his current income is not affected by his decision. The court concluded that the contributions did not constitute income to the partnership (Pet. 38, 40), even on the entity theory.

Like the Court of Appeals, we do not accept the entity approach, but we agree that even if taken it does not cause these contributions to become income to the partnership. We would add to what the Court of Appeals said that for those contributions to be income to the partnership, it should have some power to effect their reallocation among the partners, as they change from time to time. For example, if these funds are sufficiently under the partnership control to constitute income to it, then it should be the one to make the election whether to include a particular physician in the plan, and it should be able at any time to direct forfeited tentative accounts to those who are then partners, and particularly to assume control of forfeited accounts of those who are only employees, and allocate them to partners. None of these can it do, under the contract (Pet. 33; R. 164). Partners may join and become part owners of the partnership, but while they may bargain for the size of their distributive shares, they cannot bargain for any share in the tentative accounts forfeited by the partners whose vacancies they are filling, nor can the partnership direct that they are to have such a share. The contract by which Kaiser bound itself directs that the allocation of forfeited accounts is to be made to the tentative accounts of the participants, and a new partner can share only in future contributions and forfeitures (R. 166-167). Neither the partnership nor its later partners can change this.

Moreover, service as an employee means as much as service as a partner in building up a tentative account. Age and length of service of a participant are factors in determining the size of the tentative account and they are the same whether he has served as employee or partner or a combination of both. (R. 166.) The proportionate tentative account of a participant thus has no relationship to his "distributive share" of the operating income of the partnership, and indeed he may be an employee and have none of the latter but some of the former. Paradoxically, he is fortunate to be an employee and not a partner, for petitioner would tax the additions to his tentative account not to him but to the partners. Clearly, if the partnership were the owner of these contributions it should have sufficient control over them to allocate the employees' shares to the partners so they can pay the tax on them, but it lacks even this power. Lacking even this much control, it lacks the control the concept "taxable income" requires.

Finally, the partnership is even powerless to avoid the possibility that the eventual owners of all forfeited accounts will be its employees, not its partners. This is an actual possibility under the plan, and it entirely negates the notion that the partnership had a stake in these funds sufficient to represent income to it.

Subsequent to the decision below, this Court decided *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972). There, income which was not in fact received by a national bank, and which it could not have received lawfully, was held not properly allocable to it under 1954 Code Sec. 482. On the issue whether claims can be taxed as income before the identity of the ultimate owner is established, the decision supports our position. Indeed, the majority opinion so aptly states the rules as we see them that we can do no better than quote them (405 U.S. at 403):

"In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it. 'The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income whether he sees fit to enjoy it or not.' *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

"It is, of course, well established that income assigned before it is received is nonetheless taxable to the assignor. But the assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another."

The court below expressed precisely the same views and found as fact that the partnership could not have had the Kaiser contributions on any other terms (Pet. 40).

The dissenters in *First Security Bank* did not disagree with the majority for any reason harmful to our position here. Thus, Mr. Justice Marshall stated in his dissent that:

"This is not a case involving independent companies or private individuals where we must scrupulously avoid taxing someone on money he will never receive regardless of his will in the matter." (405 U.S. at 410.)

This case is the one Mr. Justice Marshall stated was not before him.

The dissent of Mr. Justice Blackmun, in which Mr. Justice White joined, was based on considerations peculiar to Sec. 482, i.e., that the income remained within the circle of the corporate family. No such considerations are shown here. There is no suggestion that the physicians in whose favor respondents may ultimately forfeit are their relatives.[33]

---

33. The Agreed Statement of Facts states that it "is complete, and there are no material issues of fact remaining in dispute."

Nor is there any income here which the taxpayers could have had and assigned elsewhere, either without or within a related structure.

Accordingly, as the Court of Appeals held, the requisite control to constitute partnership income is absent.

III. Lucas v. Earl and Its Line of Precedents Are Irrelevant Here.

Petitioner's argument, based on *Lucas v. Earl, supra,* 281 U.S. 111 (1930), is not reached unless the Court decides each preceding argument against us. Both lower courts fully considered that case and distinguished it and its line of precedents.[34] The Court of Appeals devoted three lengthy paragraphs to analyzing it and *Helvering v. Horst, supra,* 311 U.S. 112 (1940), and an additional lengthy paragraph to distinguishing them (Pet. 38-40). Obviously, these cases were not slighted but were fully considered, even though they were first discussed by petitioner in the court below on oral argument. Its afterthought below has become its major argument here.

Petitioner's position is squarely bottomed on the entity theory, although its brief offers only assertions (Br. 20) to establish the validity of that theory. As it must even to discuss its theory of the case, petitioner speaks in terms of "services rendered by the partnership" (Br. 12)[35] and that same concept, so essential to its theory, is repeated constantly (Br. 12, 13, 14, 16, 17, as examples). Driven to find

34. Neither court discussed the cases cited by petitioner for the allegation of conflict with other courts of appeals (Pet. 6, footnote 4; Br. 14, footnote 6), probably because none of them was cited in petitioner's briefs below. As we have pointed out above (at p. 13), none of these cases involved the taxability of forfeitable amounts, or any question of the proper year to tax contingent income. They thus cannot conflict with the decision below, or support the petitioner's position here.

35. Compare the language of Sec. 701: "Persons carrying on business as partners. . . ."

words to express its contention, petitioner even refers at times to the partnership as "a taxpayer" (Br. 11, 15), which Sections 701, 702, 703 and 704 make abundantly clear it is not.

Petitioner's own statements of the rule it asks this Court to apply here are these:

> "... *taxpayer* who has *earned compensation* for services must include that compensation in *his* gross income even though, by effective asignment, payment has been *deflected* and channeled to another." (Br. 11; emphasis ours.)
>
> "... income is taxable to the entity—individual or partnership—which rendered the services. ... (Br. 14)."
>
> "If a contractual arrangement to insulate a *taxpayer* from receipt of compensation *he* earned could immunize him from taxation, the force of *Lucas v. Earl* would be reduced to wavering admonition." (Br. 15; emphasis ours except for the reference to *Lucas v. Earl*.)

Thus, petitioner conceives of the partnership as "the taxpayer," which Sections 701, 702, 703 and 704 say it is not, as the one which "rendered the services," which Sec. 701 says it is not, and as an "entity," which it cannot be in the sense of being a taxpaying entity, for it never pays any tax on its income. Yet, only in the sense that we are considering a taxpayer who normally pays the tax on his, or its, earned income can the possibility of the application of *Lucas v. Earl* even be discussed.

So the first flaw in petitioner's use of *Lucas v. Earl* is that the partnership will not pay a tax on its income, whether or not petitioner's further statement that that income has been "deflected" to the trust is true (Br. 14, 15).

Analysis of the "deflected" concept also strips it bare of substance. The partnership, not a taxpayer, is said to

have "deflected" the Kaiser contributions to the trust, which is also not a taxpayer.[36] Thus, petitioner has told the Court that *Lucas v. Earl* prohibits the deflection of income from one non-taxpayer to another!

To restore reality to any possible application of *Lucas v. Earl*, one must break through the insulation of two non-taxpayers to the actual taxpayers. The taxpayers on the net income attributed to the partnership are the partners.[37] Sec. 701. The taxpayers on the trust's receipts from Kaiser are either the partners,[38] as petitioner contends, or the partners and employees who ultimately receive them, as we contend. Now that we have penetrated that insulation, we see that the effect of what petitioner calls a deflection is primarily to defer the partners' income to the future when they will have fully earned it and can receive it, and, if our position is sustained, to tax the employee and not the partner on what is ultimately paid to the employee for his services.

Thus, our position will tax the amounts Kaiser pays as compensation for the services of a physician to the physician who performs the services, whether he be partner or employee, but not until he has fully earned this additional compensation. Petitioner's position would tax it now to someone, even though that person may never receive it, and would distort *Lucas v. Earl* to a point where it would tax the partner on income earned by his employee.

---

36. The Trust is not a taxpayer with respect to these contributions, though it is with respect to the earnings their investment produces.

37. Kaiser's current payments for the employees' services are taxed to the employees, and are allowed as a deduction in computing partnership net income.

38. For some reason it does not explain here petitioner will not allow respondents a deduction for amounts the trust receives for the tentative accounts of employees.

We believe we need not expend argument in persuading this Court that the courts below did not err in refusing to distort *Lucas v. Earl* into support for taxing the partners on the earnings of their employees. There remains only the question of the taxable year in which the partners are taxable on the additional compensation paid to the trust for their own services. This is a question of the year of realization of income, and hence is a question *Lucas v. Earl* did not involve. Mr. Earl was taxed in the year Mrs. Earl received half of his earnings, not in some earlier year. Hence, *Lucas v. Earl* sheds no light on the real issue in his case.

As we have demonstrated above, the application to the taxpayers here of the realization rules applicable to other taxpayers postpones taxability on their forfeitable claims to these contributions to the years in which they receive them. Cases protecting the revenue from assignments of income from one taxpayer to another have a valid and necessary function to perform, but they are not restricted in their performance of that function if they are denied the role of taxing taxpayers now on income they cannot receive until future events occur and fix their right to receive it. The nonassignment cases are being distorted beyond recognition when they are asked to support a tax structure for those taxpayers who are partners to which no other class of taxpayers is required to submit.

The principle that income must be taxed to him who earns it will be satisfied if the physicians in this case are not taxed until they have fully earned this additional compensation for their services. To fully earn it they must perform further services. Each physician must work for Kaiser not only in this taxable year but in as many as fourteen succeeding taxable years after his two-year qualifying period (Pet. 32-33) in order to fully earn this income.

Unless it is earned by both fifteen years service and satisfaction of continuation requirements,[39] it is neither earned nor going to become his income.

The courts below found that the requirements for long service and forfeiture were for the benefit of Kaiser, to assure it a constant pool of physicians. (Pet. 32, 17.) This finding was based on the parties Agreed Statement of Facts (R. 83, para. 16). Recognizing how fatal this fact is to its effort to convert this case into a tax avoidance case so that it can invoke *Lucas v. Earl,* petitioner seeks to question that Kaiser's dominant purpose was real instead of merely professed (Br. 17). Having stipulated to the contrary, it removed that question from the case and cannot now reinject it.[40]

Finally, petitioner does not explain why what it calls an "anticipatory arrangement" to require fifteen years service in order to complete the earning of benefits should be stricken down by tax avoidance principles when a retroactive shifting of taxable income between partners is expressly authorized by 1954 Code Sec. 761(c). That section permits partners to shift income between themselves after the close of the taxable year. Presumably, Congress believed that partners would shift income only to reflect actual earnings and not to impoverish the Treasury by first impover-

---

39. The service requirement is less if he sooner becomes sixty-five. Then even after retirement forfeiture can occur if the physician refuses consultation or should work for a competing health plan (Pet. 33).

40. Petitioner's further suggestion (Br. 16, footnote), that the partnership had income under the revocable trust sections (Sections 674-678) has the roles reversed. Kaiser paid the contributions to the trust so it, not the partnership, is the grantor. Each of those sections states that under the described circumstances "The grantor shall be treated as the owner. . . ." Since taxpayers are not taxable on any income of which Kaiser is "treated as the owner," those sections, if applicable, are additional support for taxpayers' position.

ishing themselves. All that this "anticipatory arrangement"[41] does in deflecting income can be done retroactively under Sec. 761(c).

In summary, the question before the Court is one of time: whether the taxpayers realized income in these taxable years from the addition to their tentative accounts of entries as to which their claims were forfeitable until by further years of service they had earned the right to receive them. *Lucas v. Earl* has no bearing on questions of the time of realization of income, where the principles are established by other lines of precedent and are not in doubt. Since the principles which *Lucas v. Earl* establish have no meaning in a case in which it might void the tax effect of an assignment by one nontaxpayer to another nontaxpayer, only the effect on the underlying taxpayers has meaning, and that effect is on time, where the applicable rules are well established, and need only to be applied to the taxpayers in the same fashion they would be applied to all other taxpayers.

IV. There Is No Carefully Devised Statutory System for Taxing Forfeitable, Contingent Future Retirement Income Which the Decision Below Could Circumvent.

Petitioner contends that the decisions below circumvent the carefully planned purpose of Congress as expressed in 1954 Code Section 401, to grant tax deferment only to those retirement plans which comply with stated restrictions.

---

41. It is a play on words to call the contract "an anticipatory arrangement." It was "anticipatory" in the sense that it preceded the performance of the services. But the same contract is the source of the income and of the assignment. The taxpayers never have had any rights free of the possibility of loss through forfeiture. They have assigned nothing Kaiser would have given in any other form; they have simply failed to acquire more than it agreed to give. Thus, even if *Lucas v. Earl* controlled the time of realization of income, this case would not contain the necessary elements for its application.

Petitioner's contention is answered by a section of the Code which it does not cite: Sec. 402(b), which we will discuss. Moreover a plan such as this is not economically feasible for any employer except a tax-exempt employer, as Kaiser is here.[42]

1954 Code Sections 401-404, inclusive, deal exclusively with retirement plans established by employers for employees. A retirement plan which qualifies under all the restrictions of those sections has these characteristics: The employer gets an immediate deduction for its contributions to the plan (Sec. 404); the investment earnings of the fund are tax-free because the trust is exempt from tax (Sec. 501(a)); and the beneficiary is not taxable on anything until he receives it (Sec. 402(a)), even if his interest is not forfeitable (Treas. Reg. Sec. 1.402(a)-1(a)(1)(i)).

A retirement plan for employees which does not qualify for any reason receives contrasting treatment. The employer gets no current deduction for contributions to the trust (Sec. 404(a)), the nonqualifying trust is nonexempt because Section 501(a) exempts only qualifying trusts,[43] and if the employee's rights to contributions under a nonqualifying plan are vested when the contributions are made, the employee is taxable currently (Sec. 402(b)). However, as is the case with qualifying plans, the beneficiaries of nonqualifying plans are not currently taxable on the contributions if their right to them is forfeitable when the employer's contribution is made (Sec. 402(b)).

Congress has thus declared explicitly that its carefully structured scheme to favor retirement plans which do not

---

42. The record (R. 82) states that during the years in issue Kaiser was a non-profit corporation but does not disclose the further fact that it was ruled tax-exempt by the Revenue Service.

43. Hence, this trust is taxable on the earnings of the fund and petitioner did not appeal from the District Court decision so holding (Pet. 34, note 1.)

discriminate in favor of executives and shareholder-employees, or contain other prohibited features, is not defeated by deferring the beneficiary's tax on contributions made under a nonqualifying plan, provided the beneficiary's rights are forfeitable.

Subsequent to the taxable years here involved, Congress enacted a carefully limited scheme permitting tax incentives for retirement plans for the self-employed.[44] While the status of a plan in effect in 1961, 1962 and 1963 cannot be affected by radiations from a statute enacted four years later, we think the Court should be apprised of the differences. The 1967 statute applies only to income a self-employed person has first reduced to possession, and it allows him a deduction if he pays it over to a trustee in the taxable year. It eliminates nothing from his gross income, unlike Sections 402(a) and 402(b), but allows him a deduction. The fact that Congress has allowed this deduction from income has no tendency to suggest it would wish taxpayers taxed on income subject to forfeiture.

Within the context of this case, the most significant fact in measuring the Congressional purpose in adopting the 1954 Code is that Sections 401-404, inclusive, are more detailed versions of Sec. 165 of the 1939 Code, and the provisions deferring the tax on beneficiaries of both qualified and nonqualified plans now found in Sections 402(a) and 402(b) are taken virtually verbatim from the former [1939 Code] Sections 165(b) and 165(c). The entire 1954 Code is an elaborate and painstaking work and reflects intensive Congressional thought in formulation, drafting and adoption. The decisions on which we rely in *Schaefer v. Bowers, supra,* 50 F. 2d 689; *Julian Robertson, supra,* 6 T.C. 1060; and *Harold Perkins, supra,* 8 T.C. 1051, were decided in

---

44. Under Pub. Law 90-607, changes adding to Sections 401(c) and (d) to the Code were made effective after Dec. 31, 1967.

1931, 1946 and 1947, respectively. The acquiescences in the latter two were published in 1946 and 1947, respectively, and the *Schaefer* case approved a Government argument. Congress must be assumed to have been aware of these decisions and of the administrative position the acquiescences represented. (Cf. *Commissioner v. LoBue*, 351 U.S. 243, 249 (1956).) It must have known that the new statute with its similar definition of gross income would be understood to mean the same as the old, and receive the same administrative construction, unless Congress modified it where it wanted the new statutes to be different.[45] Neither in Sec. 61 nor elsewhere has Congress shown a purpose to have the new Code be different from the old insofar as inclusion of forfeitable property in income is concerned, whereas in Sec. 402(b) it has expressly stated its purpose to continue to defer tax on forfeitable contributions to a nonqualifying plan.

The charge that the decision below opens the door to wholesale partnership plans which avoid the restrictions placed on the self-employed is a loose one. In going to the extraordinary extent of permitting the self-employed to place some of their fully earned and received gross income in a retirement trust and obtain a deduction for so doing, Congress naturally imposed restrictions. Those restrictions would have no place in a plan where the self-employed has unearned rights not yet ripened into gross income.

The practical answer is that by its nature this plan is extraordinary. It is part of an over-all scheme whereby a

---

45. We do not contend that these judicial and administrative precedents tie this Court's hands under the re-enactment doctrine [cf. *Higgins v. Commissioner*, 312 U.S. 212, 215-216 (1941)]; our contention is that an inference of lack of Congressional concern over the probable continuation of prior interpretations is permissible. Congress would have legislated in some manner to represent a change if it had wished to confine all deferred compensation to employee cases.

partnership and a client mutually contemplate exclusivity for more than fifteen years, to promote the client's purpose, not that of the partnership. It is difficult to think of a parallel likely to occur in legal, medical or other professional practice.

Perhaps the closest parallel to this case is the insurance general agent, and he is a numerous example. Yet, the Commissioner has agreed that he should enjoy deferment of retirement income. Rev. Rul. 60-31, 1960-1 Cum. Bull. 174, 180, acquiescing in *James F. Oates*, 18 T.C. 570, affirmed sub nom. *Commissioner v. Oates*, 207 F. 2d 711 (C.A. 7, 1953), cited, *supra*.

If any threat to the revenue does exist, the defense to it does not lie in taxing the earner on contributions which are forfeitable and which he may never enjoy, but instead in statutes patterned after 1954 Code Section 404(a)(5)[46] which would deny the employer deductions for contributions to a nonqualifying plan for independent contractors until such time as the beneficiary becomes taxable. There would be no need to legislate taxability of the investment income of the trust fund since that is presently taxable, as in the present case. Injustice to taxpayers whose claims to future benefits are contingent and forfeitable is not only an inappropriate method of protecting the revenue, but is not the one which Congress adopted when it acted to curb the threat posed by nonqualified employee retirement plans.

In weighing the impact of a decision for the taxpayers on other plans, now in effect or created in the future, the Court may properly consider the circumstances making this case unique, even though not disclosed by the record. Full consideration must be given to the fact that the Health Plan, Kaiser, was tax-exempt. As a tax exempt organization, it

---

46. Section 404(a)(5) was amended in 1969. The amendment was not retroactive in effect and does not apply to the tax years involved herein.

was not concerned that the payments to a nonqualified plan would not be deductible. An industrial or commercial employer, however, would not place itself in this position. It would not establish a non-qualified plan because its payments to such a plan could not be deducted for tax purposes.

CONCLUSION

The decision of the Court of Appeals is correct and should be affirmed.

Respectfully submitted,

VALENTINE BROOKES
LEONARD ALLEN MARCUSSEN
LAWRENCE V. BROOKES
By VALENTINE BROOKES
Attorneys for Respondents

(Appendix follows)

Appendix

1939 Internal Revenue Code (Title 26 U.S.C.) Section 22(a)—Gross Income—Definition—

GENERAL DEFINITION.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

[The 1954 Internal Revenue Code Sections and Regulations thereunder appear as in effect during the years 1961-63.]

1954 Internal Revenue Code (Title 26 U.S.C.) Section 61(a)—Gross Income Defined—

GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 402(b)—Taxability of Beneficiary of Employees' Trust—

TAXABILITY OF BENEFICIARY OF NON-EXEMPT TRUST.—Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501 (a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made. The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities), except that section 72(e) (3) shall not apply.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 404(a)(5)—

Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan.—

(a) GENERAL RULE.—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or

annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

. . . .

(5) OTHER PLANS.—In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 701—Partners, Not Partnership, Subject To Tax.

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 702—Income And Credits of Partner.

(a) GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

(1) gains and losses from sales or exchanges of capital assets held for not more than 6 months,

(2) gains and losses from sales or exchanges of capital assets held for more than 6 months,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170 (c)),

(5) dividends with respect to which there is provided an exclusion under section 116, or a deduction under part VIII of subchapter B,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in section 35 or section 242 (but, if the partnership elects to amortize the premiums on bonds as provided in section 171, the amount received on such obligations shall be reduced by the reduction provided under section 171 (a) (3)),

(8) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

(b) CHARACTER OF ITEMS CONSTITUTING DISTRIBUTIVE SHARE.—The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

(c) GROSS INCOME OF A PARTNER.—In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 703(a)—Partnership Computations.—

INCOME AND DEDUCTIONS.—The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) the items described in section 702 (a) shall be separately stated, and

(2) the following deductions shall not be allowed to the partnership:

(A) the standard deduction provided in section 141,

(B) the deductions for personal exemptions provided in section 151,

(C) the deduction for taxes provided in section 164 (a) with respect to taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(D) the deduction for charitable contributions provided in section 170,

(E) the net operating loss deduction provided in section 172, and

(F) the additional itemized deductions for individuals provided in part VII of subchapter B (sec. 211 and following).

1954 Internal Revenue Code (Title 26 U.S.C.) Section 704 (a) and (b)—Partner's Distributive Share.—

(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO.—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income

or loss of the partnership, as described in section 702 (a) (9), for the taxable year, if—

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

1954 Internal Revenue Code (Title 26 U.S.C.) Section 761(c)—Terms Defined—

PARTNERSHIP AGREEMENT.—For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

Treas. Reg. (26 C.F.R.) Section 1.61—2(d)(5)—Gross income—

Property transferred subject to restrictions. Notwithstanding any other provision of this paragraph, with respect to any property, other than an option to purchase stock or property, which is transferred by an employer to an employee or independent contractor as compensation for services, and which is subject to a restriction which has a significant effect on its value, the rules of paragraph (d) (2) of § 1.421-6 shall be applied in determining the time and the amount of compensation to be included in the gross income of the employee or independent contractor. For special rules relating to options to purchase stock or other property which are issued as compensation for services, see § 1.61-15 and section 421 and the regulations thereunder. This subparagraph is applicable only to transfers after September 24, 1959.

Treas. Reg. (26 C.F.R.) Section 1.402(b)—1(a)(1) and (2)(i)—

EMPLOYEE PLANS.—Treatment of beneficiary of a trust not exempt under section 501(a).—(a) *Taxation by reason of employer contributions.* (1) Except as provided in section 402(d), any contribution made by an employer on behalf of an employee to a trust during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 501(a), shall be included in income of the employee for his taxable year during which the contribution is made if the employee's beneficial interest in the contribution is nonforfeitable at the time the contribution is made. If the employee's beneficial interest in the contribution is forfeitable at the time the contribution is made even though his interest becomes nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee at the time his interest becomes nonforfeitable.

(2)(i) An employee's beneficial interest in the contribution is nonforfeitable within the meaning of sections 402(b), 403(b), 403(c), and 404(a)(5) at the time contribution is made if there is no contingency under the plan which may cause the employee to lose his rights in the contribution. Similarly, an employee's rights under an annuity contract purchased for him by his employer change from forfeitable to nonforfeitable rights within the meaning of section 403(d) at that time when, for the first time, there is no contingency which may cause the employee to lose his rights under the contract.

Treas. Reg. (26 C.F.R.) Accounting Methods—

§ 1.451-2. Constructive receipt of income.

(a) *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received

by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.